

**1980
ANNUAL
REPORT**

Paloma

Petroleum Ltd.





CORPORATE HIGHLIGHTS

	1980	1979
FINANCIAL		
Gross revenue	\$ 7,963,588	7,270,672
Funds provided from operations	4,106,637	3,362,833
Per share	.40	.37
Net earnings before extraordinary items	1,749,528	1,287,370
Per share	.17	.14
Net earnings	1,868,028	1,402,807
Per share	.18	.16
OPERATIONS		
Natural gas sales (MCF)	3,152,017	4,262,261
Daily average	8,636	11,677
Crude oil and condensate production (barrels)	154,752	170,358
Daily average	424	467
Proven reserves:		
Natural gas (MCF)	93,170,000	81,326,000
Crude oil and condensate (barrels)	1,943,293	1,956,142
Probable additional reserves:		
Natural gas (MCF)	18,490,000	18,425,000
Crude oil and condensate (barrels)	490,453	490,453
Land holdings including royalty interests		
Gross acres	961,182	846,704
Net acres	157,923	134,448
Wells drilled		
Gas	34	39
Oil	10	11





REPORT OF THE DIRECTORS TO THE SHAREHOLDERS



The Company has increased its U.S. activities since the Canadian Federal Budget and National Energy Program came out on October 28, 1980. Paloma will be participating in a number of wells in Texas, south Oklahoma and south Louisiana with knowledgeable partners in those areas who have operating capabilities and access to drilling rigs. This will involve us in approximately \$60 million worth of

drilling or at least 70 wells ($\frac{2}{3}$ development wells and $\frac{1}{3}$ medium risk exploration wells). The Company's level of participation will generally be in the 10% to 12.5% range. The drilling program will include 15 exploration wells in west Texas, a 5 to 15 well program in the Giddings field of the Austin Chalk play in Fayette County, Texas, 1 salt dome prospect in Plaquemines Parish, Louisiana and, in south Oklahoma, the Company will participate in the drilling of 10 development wells plus the acquisition of acreage in the Marietta Basin. We believe that such a diversified exposure in established producing areas in the U.S. will enhance the Company's growth potential and we are, therefore, allocating about $\frac{2}{3}$ of our planned \$12 million 1981 capital budget to U.S. projects.

In Canada, Paloma will concentrate on the Birch Wavy gas contract area in east central Alberta. This is a 216 township (4,977,000 acre) block where the Company can operate profitably because it has a contract with TransCanada PipeLines Limited through 1996 which makes it possible to put new reserves on stream on an annual basis. Our exploration in the northern part of the block in late 1980 and early 1981 has resulted in 6 gas discoveries, and 7 to 10 additional locations will soon be drilled. The Company has been making effective use of seismic surveys in this area which has a number of potential gas sands in the 670 to 762 metre (2200 to 2500 foot) range. Our wells have averaged 3 BCF of gas reserves each and the Company's land holdings in the general area total 11,520 gross acres (7,056 net acres).

Gas production was down 25% in 1980 relative to 1979 due to the weak U.S. gas export market. Much of Paloma's production is sold through Alberta and Southern Gas Co. Ltd. to the California market where lower priced residual fuel and U.S. gas are increasingly displacing higher priced Canadian gas. This particular situation is not expected to improve in 1981. However, TransCanada PipeLines Limited has negotiated some new gas sales contracts in the eastern U.S. which should improve the gas market situation in Alberta as will the completion of the western leg of the Alaska pipeline which will make it possible to commence sales to Pan-Alberta Gas Ltd.



At present Paloma has 71% of its gas reserves under long term contracts and an additional 13% of its reserves committed to Pan-Alberta Gas Ltd. with whom sales volumes should be fully established by November 1, 1982. The remaining 16% of our reserves are shut-in and we are exploring marketing opportunities with Alberta industrial users.

Total revenues were \$7,963,588 in 1980 compared to \$7,270,672 in 1979; funds from operations were \$4,106,637 in 1980 compared to \$3,362,833 in 1979; and earnings before extraordinary items were \$1,749,528 in 1980 compared to \$1,287,370 in 1979. The rise in income has been greatly restricted by weak gas markets and has caused us to look for growth opportunities in the U.S. The Company received approximately \$1 million in gas pre-payments in 1980 in accordance with "take-or-pay" contract provisions.

Paloma in 1980 participated in 57 wells of which 77% were productive; 34 gas wells and 10 oil wells. Our 1980 activities resulted in new reserves of 13.447 BCF of gas and 124,486 barrels of oil and condensate. The Company's total proven and probable reserves at year end were 111.660 BCF of gas and 2,433,746 barrels of oil and condensate, representing a 35.4 year gas supply and a 15.7 year supply of oil and condensate at current producing rates.

At the end of 1980 the wholly-owned subsidiaries Compass Investments of Alberta Limited, Conquest Oil & Mining Ltd. and Compass Resources Ltd. were all amalgamated into Paloma Petroleum Ltd., thus streamlining our administration.

Paloma has applied to the Canadian Petroleum Monitoring Agency for a 1981 Canadian Ownership Certificate. The Company calculates its COR at 90% which if approved will qualify Paloma for maximum grants under the Petroleum Grant Program.

Although the current political atmosphere is curtailing some of our activities in Canada and is forcing the Company to expand in the U.S. we

believe this diversification might turn out to be very beneficial to the growth of Paloma. We are confident that the current political difficulties will be resolved and that the Company's greatest future potential is in western Canada.

We have a dedicated staff of 15 employees and their efforts have been greatly appreciated.

On behalf of the Board of Directors.

A handwritten signature in cursive script, reading "John E. Stobart".

John E. Stobart, President



REVIEW OF 1980 OPERATIONS

DRILLING

Paloma Petroleum Ltd. and its subsidiaries participated in the drilling of 57 wells in 1980. We were the operator for 35% of the wells and our average participation was 23%. Drilling activity resulted in 34 gas wells, 10 oil wells and 13 dry holes. Fifty wells were drilled in Alberta (31 east central, 6 central and 13 in the Peace River area); 1 well was drilled in southern Saskatchewan and 6 wells were drilled in the United States (1 in Montana, 2 in northwest Texas and 3 in northwest Louisiana). Paloma's drilling record for the year is summarized as follows:

Wells	Gross	Net
Exploratory.....	24	6.96
Productive.....	15	4.18
Dry.....	9	2.78
Development.....	33	6.27
Productive.....	29	5.59
Dry.....	4	.68

PRODUCTION:

Natural Gas:

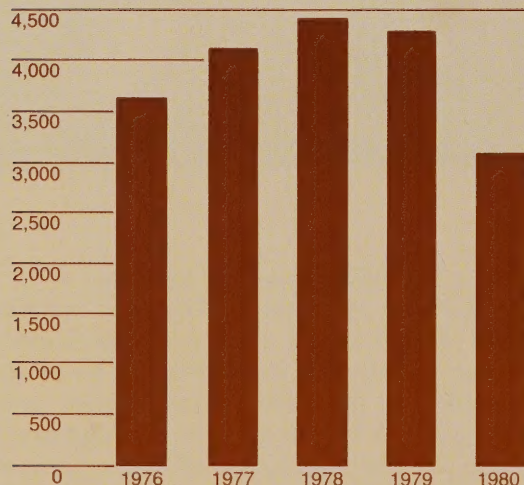
Gas sales decreased to 3,152,017 thousand cubic feet in 1980 from 4,262,261 thousand cubic feet in 1979. Production was down because of reduced sales demands in all areas and particularly in the Peace River area. Most areas were shut down approximately 4 months during the summer.

Oil and Condensate:

Crude oil and condensate production decreased to 154,752 barrels in 1980 from 170,358 barrels in 1979. Production was down mainly because of reduction of gas sales from the Dunvegan unit and subsequent reduction in condensate production.

NATURAL GAS

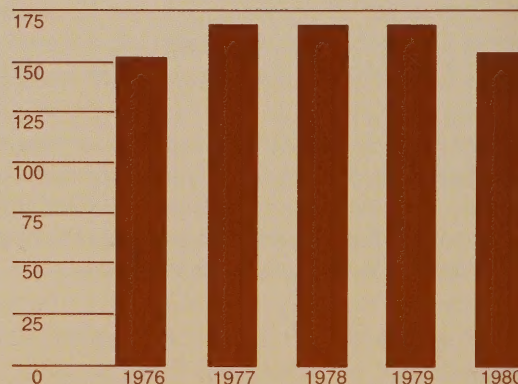
PRODUCTION (Before Royalties)
MILLION CUBIC FEET



CRUDE OIL AND CONDENSATE

PRODUCTION (Before Royalties)

THOUSAND BARRELS





RESERVES

The Company's total proved and probable reserves at year end were 111,660 million cubic feet of gas, representing a 35.4 year constant rate reserve life index, and 2,433,746 barrels of oil and condensate representing a 15.7 year constant rate reserve life index. Our 1980 drilling and acquisition program resulted in additions to reserves of 13,447 million cubic feet of natural gas and 124,486 barrels of crude oil and condensate.

(Before Deduction of Royalties)
December 31, 1980

	<u>Proved</u>	<u>Probable</u>	<u>Total</u>
CRUDE OIL AND CONDENSATE			
(Barrels)			
Province of Alberta.....	1,575,844	485,734	2,061,578
Province of Saskatchewan.....	289,412	—	289,412
U.S.A.....	78,037	4,719	82,756
TOTAL.....	<u><u>1,943,293</u></u>	<u><u>490,453</u></u>	<u><u>2,433,746</u></u>
NATURAL GAS (MCF)			
Province of Alberta:			
Peace River Area	41,153,000	12,380,000	53,533,000
Other.....	48,015,000	5,992,000	54,007,000
U.S.A.....	4,002,000	118,000	4,120,000
TOTAL.....	<u><u>93,170,000</u></u>	<u><u>18,490,000</u></u>	<u><u>111,660,000</u></u>



PRICES AND MARKETS

The price schedules for our petroleum and natural gas were laid down by the National Energy Program in the October 28, 1980 Federal Budget. The Program provides for incentive prices for oil sands, heavy oil and tertiary oil but dictates that the price of conventional oil will rise much more slowly. The current wellhead price for conventional oil is \$17.75/bbl and is set to increase \$1.00/bbl every six months until mid-1983, \$2.25/bbl every six months until mid-1985 and \$3.50/bbl every six months until mid-1990. By 1990 the oil price will have increased to \$65.00/bbl.

Natural gas currently sells for \$2.60/MCF at the wellhead and it is predicted to reach \$7.50 to \$8.00/MCF by 1990. The forecasting of the price is complex because it is dependent on many factors which include the cost of competing fuel oils, the effect of incentive pricing to develop a market in eastern Canada and the Maritimes, prices and volumes of gas dedicated to the export markets, cost of service and taxation.

As of March, 1981 the National Energy Program had not been accepted by either the producing provinces or the industry, therefore, we expect that changes may occur and that these changes will result in more rapid increases in conventional oil and gas prices than those proposed in the National Energy Program.

The market for conventional oil will remain strong because of Canada's increasing dependence on foreign oil imports. The gas market is currently weak because of the decline in export sales which has been due to the higher price of Canadian gas at the U.S. border. This has enabled lower priced residual fuel and lower priced U.S. gas to displace Canadian gas in the California market. This situation is not likely to improve in 1981, however, TransCanada PipeLines Limited has negotiated some new sales in the U.S. and Pan-Alberta Gas Ltd. will begin moving gas through the western leg of the Alaska pipeline pre-build starting November 1, 1981 and gradually reaching full volumes by November 1, 1982.

GAS SALES CONTRACTS

Paloma has 71% of its gas reserves committed under long term contracts to TransCanada PipeLines Limited, Alberta and Southern Gas Co. Ltd., and lesser volumes to Canadian-Montana Gas Company Limited, Canadian Western Natural Gas Company Limited and Pan-Alberta Gas Ltd. The company has an additional 13% of its reserves under contract to Pan-Alberta Gas Ltd. and it is expected that full production volumes will be flowing through the pre-build facilities by November 1, 1982 with partial volumes moving by November 1, 1981. Two of our properties, Chedderville and Woking, are scheduled to begin producing November 1, 1981 at a combined rate of 4 MMCFD of which the Company share is 400 MCFD. The Company share of production will reach 2.7 MMCFD by November 1, 1982 which represents a net revenue of \$1,500,000/year. We are currently exploring marketing opportunities with Alberta industrial users for the remaining 16% of Company gas reserves.

Paloma has two important long term contracts covering large areas of Alberta. These contracts provide for sales of gas reserves established within the area on an annual or biannual basis. One contract in effect through 1995 covers 2,150,000 acres in the Peace River area of northwest Alberta, and the other covers 4,977,000 acres in the Birch Wavy Lake area of east central Alberta and lasts through 1996. Because of weak market conditions in California, where our Peace River gas is sold it has not been feasible to take advantage of the Peace River contract. However, in the Birch Wavy Lake contract area, Paloma will be producing from a minimum of 6 new gas wells in the Smoky Lake, Ukalta and Hairy Hills areas. A high level of activity is planned for the Birch Wavy Lake gas contract area in 1981.

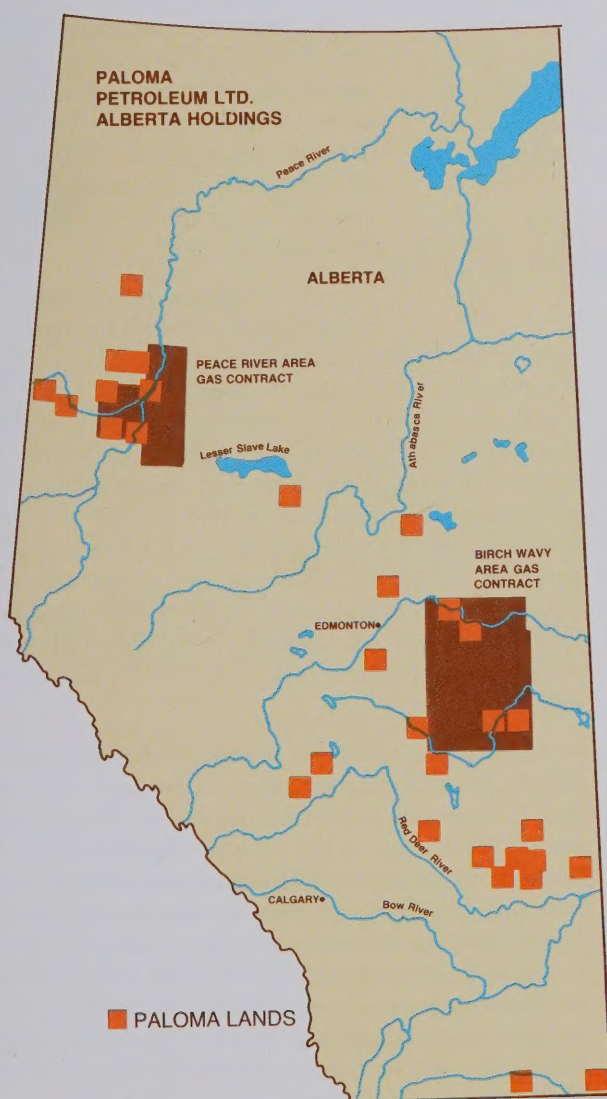


LAND HOLDINGS

CANADA

December 31, 1980

	Total	
	Gross Acres	Net Acres
Alberta	905,364	151,585
British Columbia	2,054	505
Saskatchewan	6,969	1,408
U.S.A.	46,795	4,425
	<u>961,182</u>	<u>157,923</u>



DUNVEGAN

Paloma has a 4.3% interest in the Dunvegan Gas Unit. This field is potentially the Company's largest source of production revenue. However, in 1980 there was a severe curtailment of Dunvegan gas sales for the California market due to the relatively high export price which went into effect during the first quarter of 1980. Paloma sold 920 million cubic feet of gas and 7,583 barrels of condensate from Dunvegan in 1980. Paloma's net revenue from Dunvegan in 1980 was \$1.3 million which was supplemented by \$470,000 in "take-or-pay" payments.

Unfortunately the outlook for gas sales from Dunvegan is no more promising for 1981. The field was upgraded in 1980 with additional wells and facilities and has been tested at 190 million cubic feet per day. Average deliveries in 1980 were slightly less than 60 million cubic feet per day.

PEACE RIVER AREA

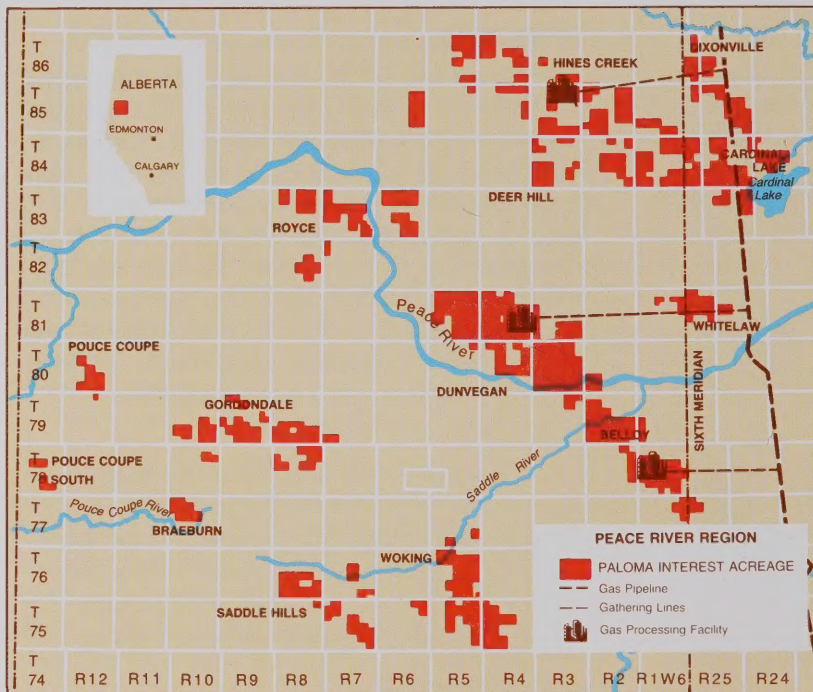
The Company has interests in 332,584 gross acres (15,486 net acres) in the Peace River area. Much of the acreage is undeveloped but it has future exploration potential. Eight exploratory wells were drilled on this acreage during 1980, resulting in four gas wells. Additional drilling will be done when gas markets improve.

Gas production from the Belloy area, in which Paloma has an 18% interest was steady at approximately 11.0 MMCFD. The Company share of annual production was 469 MMCF down from 574 MMCF in 1979 as a result of downtime for compressor repairs.

Production averaged 1.8 MMCFD at Hines Creek where our interest is 8.33%. At Woking, production averaged 1.15 MMCFD where our interest is 8.33%. Sales from Woking will increase in late 1981 when Pan-Alberta begins early deliveries through the pre-build pipeline. Other properties which will begin producing by late 1982 to Pan-Alberta are Cardinal Lake, Dixonville, Dunvegan, Gordondale, Saddle Hills, Vixen, Whitelaw and Woking. At full production volumes of 15 MMCFD, the Company's share will be 850-900 MCFD, increasing net revenue by \$500,000/year.



PEACE RIVER AREA Continued



The maximum daily production net to the Company is currently 5.0 MMCFD.

In the northern part of the Birch Wavy block Paloma has had a number of exploration successes in the Smoky Lake area. In this area there are a number of pay sands in the depth range of 670 to 762 metres (2,200 to 2,500 feet). The Company owns 11,520 gross acres (7,526 net acres), has been doing seismic surveys and has recently drilled 6 gas discoveries averaging 3 BCF per well. Seven to ten additional locations will be drilled in the spring of 1981 and all of the new gas discovered is expected to be placed on stream by November 1981.

EAST CENTRAL ALBERTA

The Company obtains 41% of its total production revenue from gas fields in the 762 to 914 metre (2,500 to 3,000 foot) depth range in east central Alberta. This area is also the focus of Paloma's current exploration activities in Canada because a large part of east central Alberta (216 townships) is covered by the Birch Wavy contract with TransCanada PipeLines (see Gas Sales Contracts Page 6). Also in east central Alberta are located most of the Company's shut-in gas reserves, estimated at 36 BCF gross (11 BCF net). These reserves are concentrated in a few pools and are well located with respect to pipelines. The Company is making attempts to sell this shut-in gas to Alberta industrial users.

The Company's most important field in east central Alberta is Jarrow where our net share of production in 1980 was 926 MMCF, a slight increase over 1979 in spite of 20% cutback in contract rates by TransCanada PipeLines. The Company revenue from Jarrow in 1980 amounted to \$1,491,600 or 26.5% of total production revenue. The daily contract quantity at Jarrow was increased 24% in 1980 and the benefit of this increase will be reflected in contract rates in 1981.

Outside of the Birch Wavy block Paloma drilled 3 new gas wells in the Oakland Lake-Berry area, 220 kilometres east northeast of Calgary. These wells found 7.8 BCF of gas of which the Company share is 3.0 BCF. The Company has 6,304 gross acres (2,994 net acres) in this area and some additional locations to drill when a gas market can be obtained. Similarly at Heathdale, 260 kilometres east northeast of Calgary, the Company has blocked out a gas field with 8 shut-in gas wells, mostly drilled in 1978 and 1 final well drilled in 1980, with further development drilling to take place when a market is obtained.

In addition to the gas reserves of east central Alberta the Company operates 7 Glauconite oil wells and 1 Glauconite water disposal well at Sibbald, just on the Alberta side of the Alberta/Saskatchewan border. The oil zone is 875 metres (2,870 feet). The gravity is 15° API and the current allowable is 30 barrels per day. Paloma's working interest is 20.25% in the wells. Paloma's wells are part of a 25 well pool where development drilling is still being continued by other operators. One major Company partner is currently doing a reservoir study which will likely result in development drilling and a water flood project which will be operational late in 1982.



The Company estimates its share of oil in place in the wells drilled to date at 1,952,100 barrels; reserves recoverable would be 15% to 22% of that figure depending on the effectiveness of the water flood.



scheduled to begin November 1, 1982 under a contract with Pan-Alberta. The contract rate from the Paloma interest lands is 4.8 MMCFD. There are currently 6 shut-in gas wells capable of 3.0 MMCFD (600 MCFD Company share) on 16,700 gross acres (3,800 net acres). Consideration will be given to development drilling in the 1981-82 drilling season to increase deliverability.

In the Chedderville area, 20 kilometres south of Rocky Mountain House, Paloma has an 11.25% interest in two D-3 gas wells and 5,120 gross acres (576 net acres). The wells are 3,620 metres (12,000 feet) deep and were drilled on the basis of seismic data. Depending on the performance of the reservoir, additional wells may be drilled. The reserves are contracted to Pan-Alberta Gas Ltd. with a contract rate of 10 MMCFD. Chedderville is an early delivery field and it is expected to be producing in late 1981 or early 1982 at one-third contract rate increasing to full contract rate on November 1, 1982.

At Hillsdown, the Company completed a 2,000 metre (6,560 foot) Nisku oil well which began pumping in October, 1980 at 30 BOPD. Paloma has a 100% working interest in this 320 acre property.

In the Garrington area Paloma acquired a 50% interest in a 320 acre lease directly offsetting the South Garrington Cardium 'B' Unit No. 1 and successfully completed a Cardium 'B' oil well which began pumping at 40 BOPD in January, 1981.

OTHER AREAS

At Rowley, located 20 kilometres north of Drumheller, Alberta, 2 wells were put on stream November, 1980 selling to TransCanada PipeLines at 500 MCFD (300 MCFD net). A seismic survey has recently been carried out in order to develop additional locations on 3½ undrilled sections held by the Company at Rowley.

Gas production from our West Hotchkiss property, 235 kilometres north of Grande Prairie, is



U.S.A.

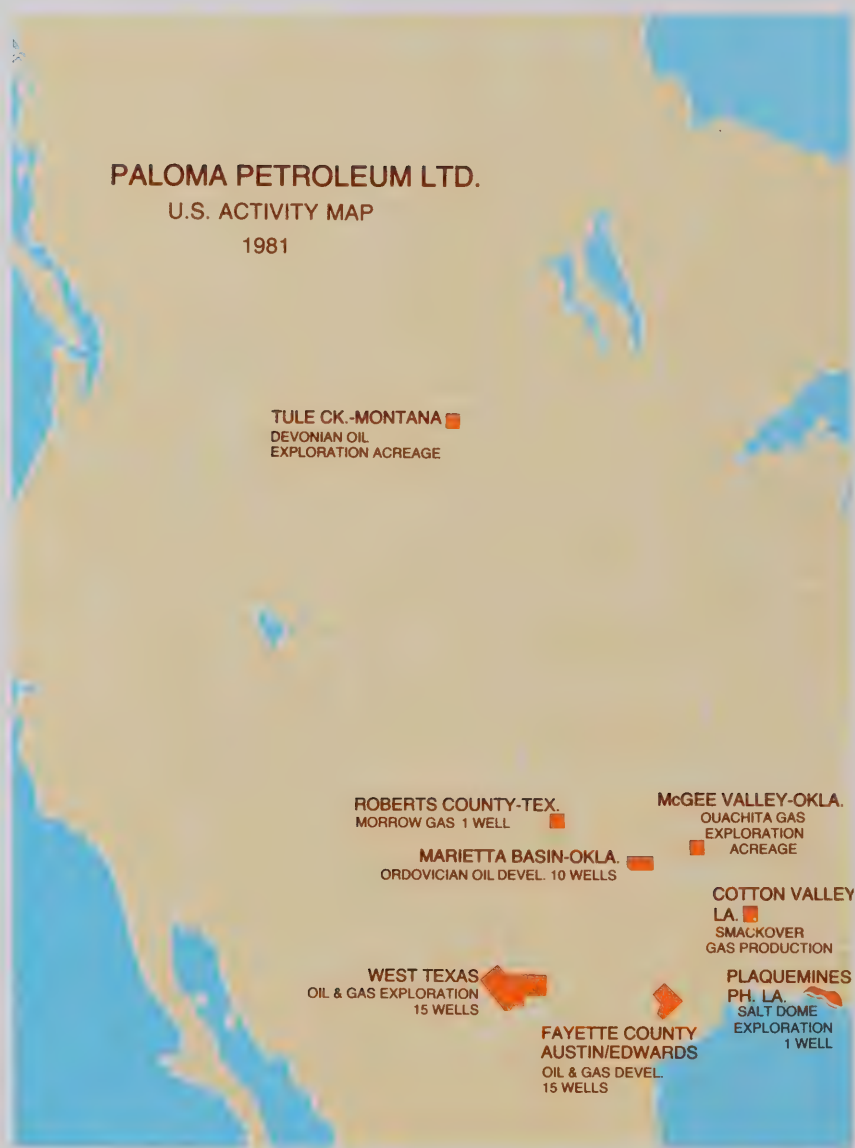
Paloma has increased its U.S. activities since the Canadian Federal Budget came out on October 28, 1980. The Company has joined in a number of areas with knowledgeable partners who have operating capability and access to drilling rigs. The accompanying map illustrates where Paloma is operating in the U.S.

WEST TEXAS

Fifteen wells averaging 3,047 metres (10,000 feet) in depth will test medium risk exploratory prospects of 10 to 20 sections in size in Pecos, Terrell and Crocket Counties. Multiple-pay oil and gas are expected in carbonate sediments of Ordovician, Devonian, Mississippian and Pennsylvanian ages. The reserve potential for a typical prospect is 40 BCF gas and 350,000 barrels of oil. Paloma's working interest is 10%.

FAYETTE COUNTY, TEXAS

Paloma has joined an experienced operator in the Austin Chalk play, one of the hottest areas in the U.S. with 137 rigs currently drilling. The Company has committed to 5 wells and has the opportunity to earn with additional wells in up to 17,000 acres of leases which are located in the south extension of the Giddings field. This field was discovered in 1976 and through the end of 1980 has produced 29.5 million barrels of oil and 52.4 BCF of gas from 824 producing wells. The oil comes from fractured limestone reservoirs believed to be detectible with modern seismic methods which are being used by Paloma and partners. Reservoirs are usually stimulated by hydraulic fracturing. Wells are characterized by initial rates of production as high as 1,000 barrels per day and fairly rapid decline rates. Nevertheless a number of wells have paid out in less than a year, are still producing and their ultimate production is still to be determined.





MARIETTA BASIN, OKLAHOMA

This play which is located in south Oklahoma near Ardmore is drawing increasing attention from major companies and knowledgeable independents. Production of 38° gravity oil is obtained from thick zones of Ordovician Viola limestone at 1,828 to 3,047 metres (6,000 to 10,000 feet). Reserves per well are estimated at around 300,000 barrels. Paloma has a 12.5% working interest in a 10 well development drilling program on a 1,000 acre drilling block. Paloma has agreed to join the operator in acquiring trend acreage in the area.

ROBERTS COUNTY, TEXAS

The Company has 9,600 acres (960 net acres) in Roberts County, located in the Texas Panhandle. A gas well drilled in 1980 will soon go on stream at a rate of one million cubic feet per day. Production is from the Morrow formation at 3,047 metres (10,000 feet). At least one follow-up well will be drilled in 1981. Paloma's working interest is 10%.

PLAQUEMINES PARISH, LOUISIANA

An exploratory well will be drilled in March, 1981 to a depth of 3,885 metres (12,750 feet) to test for Miocene sand reservoirs on an untested flank of a salt dome. The potential reserves are 1 million barrels. Paloma's working interest is 10%. The well will be drilled from a barge location.

OTHER U.S. PROPERTIES

The Company holds a 3.75% working interest plus a .94% overriding royalty in 22,000 acres on the eastern and southern flanks of the Cotton Valley field located 60 kilometres northeast of Shreveport, Louisiana. To date there are 8 completed wells, 7 on stream and 1 soon to be connected. The wells produce gas and minor condensate at about 1 MMCFD per well from the Smackover (Grey) Sand 3,352 metre (11,000 foot) depth.

In McGee Valley, eastern Oklahoma, Paloma has 12,810 acres gross (1,922 acres net). There is growing industry interest in attempting to produce gas from the relatively tight Ouachita formation in this area. There is pipeline access and 1 or 2 wells may be drilled on or near Paloma lands this year.

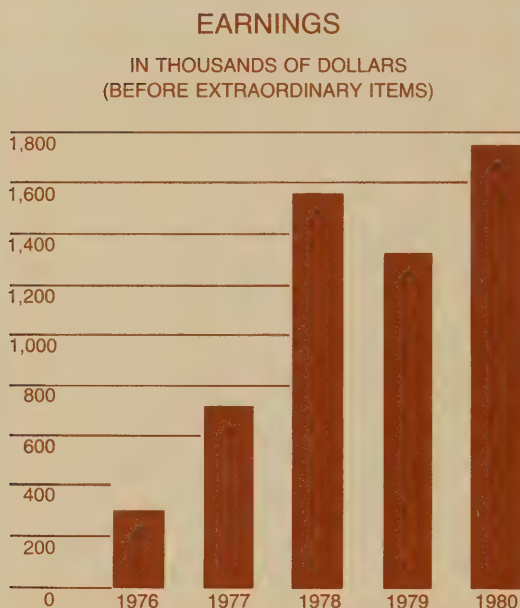
At Tule Creek, in the Williston Basin, Roosevelt County, Montana, Paloma has acquired an interest in 3,665 gross acres (770 net acres). In the vicinity there are a number of Devonian oil pools which are small in area and difficult to locate but contain up to 7,000,000 barrels of oil. Paloma has deferred future drilling at Tule Creek pending the results of current activity in the area.



FINANCIAL REVIEW

EARNINGS

Net earnings before extraordinary items amounted to \$1,749,528 for 1980, an increase of 36 percent from \$1,287,370 in 1979. This represents earnings per share of 17 cents for 1980 and 14 cents for 1979.

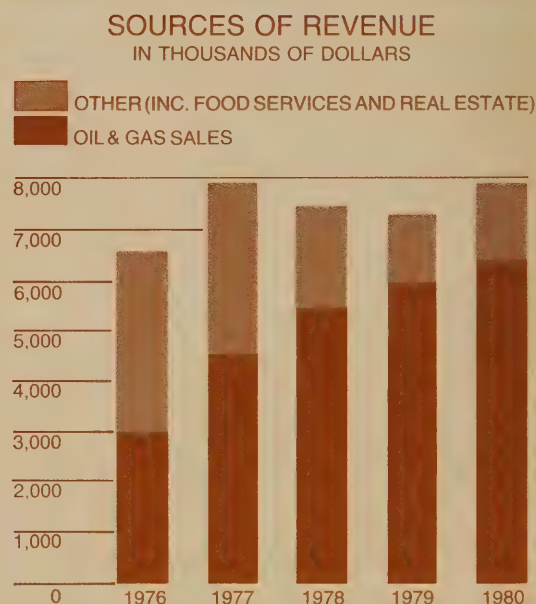


REVENUE

Gross sales from natural gas and crude oil for 1980 totalled \$10,349,509 compared to \$9,648,595 for 1979, an increase of 7 percent. Despite continued natural gas marketing problems, the increase in wellhead price more than compensated for the reduction in production volumes. After payment of Crown and freehold royalties at an approximate combined rate of 37 percent, our net petroleum revenue amounted to \$6,577,286 and \$6,020,998 for 1980 and 1979 respectively. A comparative analysis of petroleum sales and royalties is as follows:

	1980	1979
Natural gas:		
Sales	\$7,966,521	7,455,068
Royalties	2,723,326	2,642,799
Net	5,243,195	4,812,269
Crude oil and condensate:		
Sales	2,382,988	2,193,527
Royalties	1,048,897	984,798
Net	1,334,091	1,208,729
TOTAL	\$6,577,286	6,020,998

The Company's other revenue, including food services and real estate, increased 11 percent in 1980 to \$1,386,302 compared to \$1,249,674 for 1979. Increased interest rates paid on deposits in 1980 were a contributing factor to this increase.





EXPENSES

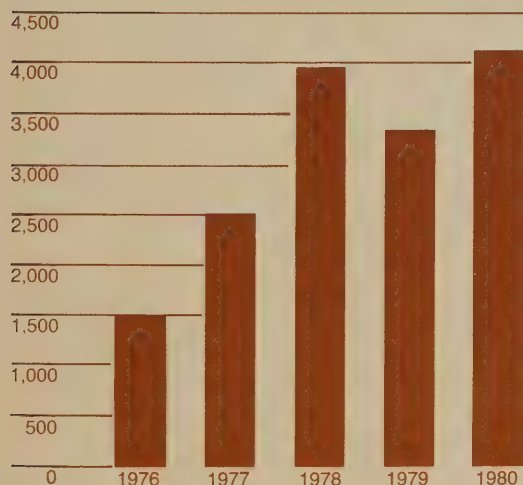
Total expenses for 1980 increased 5 percent to \$6,057,927 from \$5,762,082 the previous year. Reduced 1980 natural gas production volumes were production expenses as well as depletion and depreciation. Paloma calculates its depletion on petroleum and natural gas properties and depreciation on production equipment on a unit-of-production method.

General and administration expenses of \$1,109,068 in 1980 is an increase of 28% from 1979. Increased corporate costs resulting from the 1979 year end underwriting and a Company evaluation performed during 1980, as well as general inflationary trends all contributed to the additional general and administrative expense.

The Company's long-term debt structure remained intact during 1980. The fluctuating prime interest rate, which reached a high of 18.25 percent during the year, accounted for the 10 percent increase in the interest expense from the previous year.

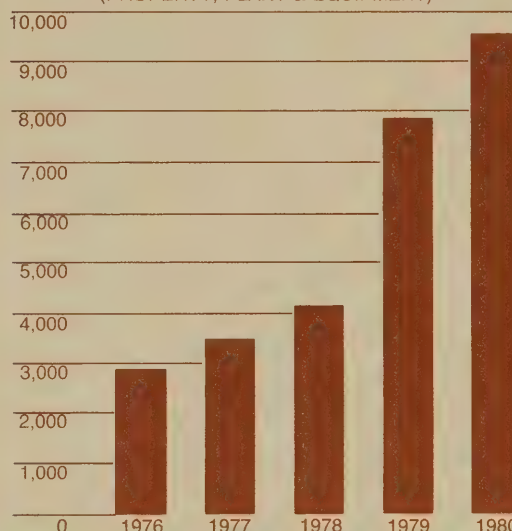
FUNDS PROVIDED FROM OPERATIONS

IN THOUSANDS OF DOLLARS



CAPITAL EXPENDITURES

IN THOUSANDS OF DOLLARS
(PROPERTY, PLANT & EQUIPMENT)



CHANGES IN FINANCIAL POSITION

Funds from operations of \$4,106,637 (\$.40 per share) represents an increase of 22 percent from \$3,362,833 (\$.37 per share) in 1979. Working capital at December 31, 1980 amounted to \$3,542,093 compared to \$8,128,349 at December 31, 1979.

The major portion of the Company's contracted producing natural gas interests are subject to the take-or-pay provisions included in the contract. During 1980 the net payments received for contracted gas, which was not produced and sold, amounted to \$976,389 compared to \$347,794 for 1979. For accounting purposes the take-or-pay payments are classified as deferred revenue and accordingly are not included in earnings until such time as the purchaser takes delivery of the gas or the take-or-pay time provision within the contract expires.



Capital expenditures during 1980 totalled \$9,610,896 compared to \$7,907,562 in 1979, an increase of 22 percent. Approximately 92 percent of the 1980 capital expenditures were incurred in the province of Alberta with the remaining 8 percent in the United States. With the changing economic conditions and circumstances in Canada, we anticipate a significant shift of capital expenditures south of the border during 1981. A comparative capital expenditure analysis is as follows:

	1980	1979
Land	\$2,993,185	1,632,965
Exploration	3,093,591	2,945,650
Development	1,946,892	2,412,942
Production facilities	1,577,228	916,005
	<u>\$9,610,896</u>	<u>7,907,562</u>

OUTLOOK FOR 1981

Effective December 31, 1980, Paloma and its wholly-owned Alberta subsidiaries were amalgamated. This amalgamation was accomplished to facilitate the ease of operation and administration of the Company. At the same time as the amalgamation was approved, the Memorandum of Association of the Company was amended and the authorized capital of the Company was increased to 25,000,000 common shares without nominal or par value and a preferred share class was established.

In January of 1981 the Company was successful in re-negotiating its long-term loan with the Canadian Commercial & Industrial Bank. The principal amount of the loan has been increased to \$16,000,000 and the interest rate is $\frac{1}{4}$ of one percent over the bank's prime lending rate. The security for the loan remains unchanged with no principal repayments required for up to 10 years. We are very pleased with the new loan as the terms are quite favourable and with no additional security required, we still have all but the one petroleum property available for security for additional financing as required.

The outlook for 1981 is somewhat overshadowed by the adverse effect of the recent National Energy Policy and the seeming inability of the provincial and federal governments to resolve their differences regarding petroleum pricing and taxation. Restricted gas markets and the recently imposed 8% Petroleum Gas Revenue Tax will have an adverse effect, estimated at 24%, on the Company's 1981 cash flow. By committing approximately $\frac{2}{3}$ of its 1981 capital budget to U.S. activities the Company hopes to develop greater cash flow starting in the second half of 1981. Canadian investments will be confined to the Birch Way Gas Contract Area where we can readily market newly developed gas reserves.



AUDITORS' REPORT TO THE SHAREHOLDERS

We have examined the consolidated balance sheet of Paloma Petroleum Ltd. as at December 31, 1980 and the consolidated statements of earnings and retained earnings and changes in financial position for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests and other procedures as we considered necessary in the circumstances.

In our opinion, these consolidated financial statements present fairly the financial position of the company as at December 31, 1980 and the results of its operations and the changes in its financial position for the year then ended in accordance with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Peat, Marwick, Mitchell & Co.

Calgary, Canada
March 10, 1981

Peat, Marwick, Mitchell & Co.
Chartered Accountants



CONSOLIDATED BALANCE SHEET

December 31, 1980

(with comparative figures for 1979)

	Assets	
	1980	1979
Current assets:		
Cash	\$ 1,676,968	8,478,054
Accounts receivable	2,864,115	3,013,327
Due from the Receiver General for Canada	837,710	718,556
Prepaid expenses	102,050	46,502
Total current assets	5,480,843	12,256,439
Property, plant and equipment (Note 2)	38,237,481	28,872,189
Less accumulated depletion and depreciation	6,376,937	5,066,575
	31,860,544	23,805,614
Other assets (Note 3)	242,678	338,119
Goodwill, at cost less amortization of		
\$114,643 (1979 — \$94,432)	505,272	525,483
	\$38,089,337	36,925,655



Liabilities

	1980	1979
Current liabilities:		
Accounts payable and accrued liabilities	\$ 1,549,083	4,043,090
Current portion of long-term debt	389,667	85,000
Total current liabilities.	1,938,750	4,128,090
Prepayment for future gas deliveries	1,850,026	873,637
Long-term debt (Note 4)	12,248,192	12,641,207
Deferred income taxes	4,021,642	3,202,147

Shareholders' Equity

Share capital (Note 5)	10,001,357	9,919,232
Contributed surplus	338,000	338,000
Retained earnings	7,691,370	5,823,342
	18,030,727	16,080,574
	\$38,089,337	36,925,655

On behalf of the Board:

C. Adams, Director

John E. Stewart, Director

See accompanying notes.



CONSOLIDATED STATEMENT OF EARNINGS AND RETAINED EARNINGS

Year ended December 31, 1980

(with comparative figures for 1979)

	1980	1979
Revenues:		
Oil and gas net of royalties of \$3,772,223 (1979 — \$3,627,597)	\$6,577,286	6,020,998
Food services and real estate	880,724	821,058
Other	505,578	428,616
	7,963,588	7,270,672
Expenses:		
Oil and gas production	946,905	1,068,952
Food services and real estate	605,585	567,141
General and administrative	1,109,068	869,073
Interest on long-term debt	1,973,168	1,789,685
Depletion	1,062,853	1,098,895
Depreciation	255,581	263,570
Amortization	104,767	104,766
	6,057,927	5,762,082
Earnings before income taxes and extraordinary items	1,905,661	1,508,590
Income taxes:		
Current (recovery)	(55,697)	313,630
Deferred	937,994	623,232
Province of Alberta Royalty Tax Credit	(726,164)	(715,642)
	156,133	221,220
Earnings before extraordinary items	1,749,528	1,287,370
Extraordinary items (Note 6)	118,500	115,437
Net earnings	1,868,028	1,402,807
Retained earnings, beginning of year	5,823,342	4,420,535
Retained earnings, end of year	\$7,691,370	5,823,342
Earnings per share:		
Before extraordinary items	\$ 0.17	0.14
Extraordinary items	0.01	0.02
	\$ 0.18	0.16

See accompanying notes.



CONSOLIDATED STATEMENT OF CHANGES IN FINANCIAL POSITION

Year ended December 31, 1980

(with comparative figures for 1979)

	1980	1979
Funds provided from:		
Operations	\$4,106,637	3,362,833
Proceeds on sale of property, plant and equipment	241,618	262,512
Issue of share capital	82,125	7,204,000
Reduction in other assets	10,886	31,207
Prepayment for future gas deliveries	976,389	347,794
	5,417,655	11,208,346
Funds applied to:		
Purchase of property, plant and equipment	9,610,896	7,907,562
Reduction in long-term debt	393,015	118,162
	10,003,911	8,025,724
Increase (decrease) in working capital	(4,586,256)	3,182,622
Working capital, beginning of year	8,128,349	4,945,727
Working capital, end of year	\$3,542,093	8,128,349

See accompanying notes.



NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 1980

1. Significant accounting policies:

The Company is incorporated under the laws of the Province of Alberta and its principal activity is the exploration for and development of petroleum and natural gas reserves. The accounting policies of the Company conform with generally accepted accounting principles in Canada and significant accounting policies are summarized below:

a) Principles of consolidation:

The consolidated financial statements include the accounts of the Company and its subsidiaries, all of which are wholly-owned.

b) Property, plant and equipment:

The Company follows the full cost method of accounting for petroleum and natural gas properties whereby all costs relating to the exploration for and development of petroleum and natural gas reserves are capitalized. Such costs include those related to lease acquisitions, geological and geophysical activities, carrying charges of non-producing properties, drilling of productive and non-productive wells and overhead related to exploration. Proceeds from minor property sales are reflected as a reduction of the total capitalized costs; gains or losses on significant property sales are recognized in the statement of earnings.

Depletion of petroleum and natural gas properties and depreciation of production equipment are calculated on the composite unit-of-production method, based on estimated proven reserves, as determined by Company engineers.

Depreciation of other assets is calculated at rates designed to charge the cost of the assets to earnings over the expected useful life as follows:

Building	2% straight-line
Equipment	10-30% diminishing balance
Leasehold improvements	life of lease

c) Other assets:

Video tapes and financing costs are amortized on a straight-line basis over periods of seven years and six years respectively.

d) Goodwill:

Goodwill is amortized on a straight-line basis over thirty years.

e) Joint interest operations:

Substantially all of the Company's petroleum and natural gas exploration and production activities are conducted jointly with others and accordingly the accounts reflect only the Company's proportionate interest in such activities.

f) Earnings per share:

Earnings per share are calculated using the weighted average number of common shares outstanding during the year. Had all of the employee stock options been exercised, there would have been no dilutive effect on earnings per share.



2. Property, plant and equipment:

	1980	1979
Petroleum and natural gas:		
Petroleum and natural gas properties, at cost	\$31,120,337	23,246,923
Less accumulated depletion	5,001,432	3,938,578
	26,118,905	19,308,345
Production equipment, at cost	5,836,296	4,477,078
Less accumulated depreciation	1,108,425	983,078
	4,727,871	3,494,000
	30,846,776	22,802,345
Other:		
Land, building, equipment and leasehold improvements, at cost	1,280,848	1,148,188
Less accumulated depreciation	267,080	144,919
	1,013,768	1,003,269
	\$31,860,544	23,805,614

3. Other assets:

	1980	1979
Agreements for sale receivable, net of current portion	\$ 22,177	25,907
Video tapes, at cost less amortization of \$311,046 (1979 — \$248,837)	124,420	186,629
Drilling and other deposits, at cost	45,913	51,938
Sundry investments	27,821	28,952
Financing costs, at cost less amortization of \$111,729 (1979 — \$89,383)	22,347	44,693
	\$ 242,678	338,119

4. Long-term debt:

	1980	1979
Demand production loan	\$12,000,000	12,000,000
Bank demand loan	344,192	432,540
Note payable on video tapes, unsecured non-interest bearing, due 1981	293,667	293,667
	12,637,859	12,726,207
Deduct current portion of long-term debt	389,667	85,000
	\$12,248,192	12,641,207



The demand production loan which is secured by certain petroleum and natural gas properties and the production therefrom bears interest at the bank's prime lending rate plus 1½% and is by agreement repayable in blended monthly payments of principal and interest commencing in January 1982 and ending in 1990. Subsequent to December 31, 1980 the company renegotiated this loan in the principal amount of \$16,000,000 with interest at the bank's prime lending rate plus ¼%. The bank demand loan is secured by certain petroleum and natural gas properties, bears interest at the bank's prime lending rate plus 1½% and is, by agreement, repayable in monthly blended instalments of principal and interest of \$12,000.

5. Share capital:

- a) Effective December 31, 1980 the Company together with certain of its wholly-owned subsidiary companies entered into an amalgamation agreement and increased its authorized share capital.

The issued and outstanding common shares of the Company prior to the amalgamation were converted into common shares of the amalgamated company on a one for one basis.

	1980	1979
First Preferred Shares with a nominal or par value of \$25 each: Authorized — 2,000,000 shares Issued — Nil	\$ —	—
Common shares without nominal or par value: Authorized — 25,000,000 shares (1979 — 15,000,000 shares) Issued — 10,202,948 shares (1979 — 10,180,448 shares)	10,001,357 <u>\$10,001,357</u>	9,919,232 <u>9,919,232</u>

- b) Prior to the amalgamation referred to above the Company issued, pursuant to the employee stock option plan, 22,500 common shares for cash consideration of \$82,125.
- c) At December 31, 1980 the Company has reserved for issue 422,000 common shares pursuant to an employee stock option plan. Transactions during the year with respect to the employee stock option plan are as follows:

	1980	1979
Balance, beginning of year	350,000	—
Granted to employees	10,000	350,000
	360,000	350,000
Exercised	22,500	—
Balance, end of year	337,500	350,000

The options are exercisable as to 20% each year from the date of issue on a cumulative basis. Options with respect to 327,500 common shares are exercisable at \$3.65 per share until expiry in June 1989 and with respect to 10,000 common shares are exercisable at \$4.95 per share until expiry in June 1990.



6. Extraordinary items:

	1980	1979
Reduction of deferred income taxes resulting from application of drilling and exploration expenses by certain subsidiaries	<u>\$118,500</u>	<u>115,437</u>

7. Related party transaction:

During the year the Company participated on a joint venture basis with Merland Explorations Limited. The terms of the joint venture are considered comparable to similar transactions with non-related parties. Capital expenditures incurred and net revenues received during the year with respect to this joint venture were as follows:

Capital expenditures	<u>\$ 517,866</u>
Net revenues	<u>\$1,491,609</u>

At December 31, 1980 accounts receivable include an amount of \$591,737 due from the aforementioned related party.

An individual beneficially owns approximately 77% of the Company and approximately 33% of Merland Explorations Limited.

8. Remuneration:

The aggregate remuneration paid to directors and senior officers during the year amounted to \$301,584 (1979 — \$273,150).



CORPORATE INFORMATION

DIRECTORS:

Walter J. Adams, Calgary, Alberta
G. Clarence Elliott, Winnipeg, Manitoba
W. Roy Jennings, Calgary, Alberta
John E. Stobart, Calgary, Alberta

OFFICERS:

Walter J. Adams, Chairman of the Board
John E. Stobart, President
John J. Nadurak, Vice-President — Operations
Brian J. Waters, Vice-President — Engineering
Gordon W. Meggison, Secretary-Treasurer

HEAD OFFICE:

1150 Guinness House
727 - 7th Avenue S.W.
Calgary, Alberta
T2P 0Z7

TRANSFER AGENT AND REGISTRAR:

Montreal Trust Company
Calgary, Montreal, Toronto, Vancouver

LEGAL COUNSEL:

McLaws & Company
Calgary, Alberta

AUDITORS:

Peat, Marwick, Mitchell & Co.
Calgary, Alberta

BANKERS:

The Toronto-Dominion Bank,
Main Branch, Calgary
Canadian Commercial &
Industrial Bank, Calgary

SUBSIDIARY COMPANIES:

Conquest Resources, Inc.
Grenville Exploration Limited
Paloma Petroleums, Inc.

ANNUAL MEETING

The Annual General Meeting of the
Shareholders will be held on May 15th, 1981 in
Salon A and B, Holiday Inn, 708 - 8th Avenue
S.W., Calgary, Alberta at 2:30 p.m.

Paloma

Petroleum Ltd.

1980 ANNUAL REPORT